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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS ANTHEM WATER DISTRICT AND ITS SUN CITY WATER DISTRICT.	Docket No. W-01303A-09-0343
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS ANTHEM/AGUA FRIA WASTEWATER DISTRICT, ITS SUN CITY WASTEWATER DISTRICT AND ITS SUN CITY WEST WASTEWATER DISTRICT.	Docket No. SW-01303A-09-0343

Arizona Corporation Commission
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RUCO'S NOTICE OF FILING
TESTIMONY SUMMARIES

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the Testimony Summaries of Ralph C. Smith in the above-referenced matter.

RESPECTFULLY SUBMITTED this 27th day of April, 2010.

Daniel W. Pozefsky
Chief Counsel

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By Ernestine Gamble
Ernestine Gamble

The following is a summary of the significant issues set forth in both the direct testimony of RUCO witness Ralph C. Smith on Arizona-American Water Company, Inc.'s ("AAWC" or "Company) application for a permanent rate increase. AAWC's filing is based on the calendar test year ended December 31, 2008. RUCO's calculations use the same test year.

Mr. Smith is providing testimony on the following issues: Revenue Requirement; Rate Base; Net Operating Income, including four adjustments to AAWC's proposed Rate Base and 17 adjustments to AAWC's proposed Net Operating Income. Each of these adjustments is briefly summarized below.

Rate Base

B-1, Post Test Year Plant – Sun City Water. The Company has proposed to include in rate base the cost for a new well that was placed into service on May 27, 2009, at an amount of $1.587 million. This is being removed because it was not in service during the test year and because AAWC has failed to demonstrate special or unusual circumstances to justify inclusion of the post test year plant additions in rate base.

B-2, Agua Fria Wastewater – Retirement of Two Effluent Pumps. An adjustment is needed to remove from the Agua Fria Wastewater rate base the cost of two pumps that were retired during the test year. Two effluent pumps at the Verrado waste water treatment plant ("WWTP") were retired. The original cost for the 2 pumps is $52,636.25 and AAWC's Engineering Department has been notified that a retirement work order should be created to retire the pumps as soon as possible. RUCO Adjustment B-2 removes the original cost of the two pumps that were retired from Plant in Service and from Accumulated Depreciation.

B-3, CIAC in CWIP (All Districts Except Sun City West Wastewater). The Company's direct filing contended that Contributions in Aid of Construction ("CIAC") associated with Construction Work in Progress ("CWIP") should not be deducted from rate base, because there is no offsetting plant in rate base. The full amount of CIAC should be deducted from rate base because it is the Company's choice whether to accept plant or funds from developers, and if the Company chooses to accept plant, then the Company is not expending funds for the plant and thus has funds for other uses. Additionally, the Company's position is contrary to traditional ratemaking practices and contrary to the National Association of Regulatory Utility Commissioners ("NARUC") definition of CIAC, which does not distinguish between CIAC associated with CWIP and CIAC associated with plant in service.

B-4, Cash Working Capital (All Districts).

Mr. Smith addresses three issues with respect to AAWC's proposed Cash Working Capital allowance:

(1) the revenue lag;
(2) affiliated Service Company Management Fee payment lag; and
(3) adjustments to expenses.

1. Revenue Lag

The revenue lag is supposed to measure, on average, the time between (a) the provision of service and (b) the receipt of payment for service. It typically is comprised of three sub-component lags: (1) the service period lag, (2) the billing lag, and (3) the collection lag.

The revenue lags used by AAWC for each district is summarized in the table below:

Summary of Revenue Lag as calculated by AAWC					
Revenue Lag Component	Anthem Water	Sun City Water	Anthem Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
Service Period Lag	15.148	15.219	15.248	15.335	15.394
Billing Lag	4.875	4.426	4.711	4.317	4.216
Collection Lag	26.082	26.082	26.082	26.091	26.018
Total Revenue Lag Days	**46.105**	**45.727**	**46.040**	**45.743**	**45.628**

The revenue lags used by AAWC of over 45 days are considerably longer than the comparable revenue lags used in each of these recent rate cases by other large Arizona utilities that bill their customers monthly.

The Company's lead lag study uses a collection lag, by service area, ranging from 26.018 days to 26.091 days. This effectively assumes that customers, on average, throughout the year, are not complying with the payment terms. The payment terms are supposed to be reflected in the dates printed on the customers' bills and with the terms of AAWC's tariff. As discussed in more detail below, the due date for payment of billings for water and wastewater service is 20 days and does not differ by the type of customer.

The collection lag period used by AAWC is excessive and would penalize all customers, including the vast majority of customers that pay their utility bills on time, for the minority of customers who either paying their bills late or do not pay at all (i.e., whose bills become uncollectible).

A reasonable adjustment to the collection lag can be made by applying the 20 day due date period as the maximum collection lag that would apply for customers who, on average, pay their utility bills on time.

This adjustment resulted in the revised revenue lags for each service district as follows:

Adjusted Revenue Lag Days with 20-Day Collection Lag					
Revenue Lag Component	Anthem Water	Sun City Water	Anthem Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
Service Period Lag	15.148	15.219	15.248	15.335	15.394
Billing Lag	4.875	4.426	4.711	4.317	4.216
Collection Lag	20.000	20.000	20.000	20.000	20.000
Total Revenue Lag Days	**40.023**	**39.645**	**39.959**	**39.652**	**39.610**

2. Service Company Payment Lag

In its direct filing, AAWC applied a payment lag of 14.7715 days for Affiliated Management Fees, as shown on line 7 of AAWC's Schedule B-6, in the "Expense Lag Days" column for each district. Had AAWC not indicated in response to a RUCO data request that it wanted to drastically revise this lag and instead reflect a pre-payment of the affiliated Management Fees, Mr. Smith would not have objected to the payment lag of 14.7715 days that AAWC reflected in its filing, since it appears to be within a range of commercially reasonable terms such as payment lags to non-affiliated vendors.

In response to RUCO 2-75, however, AAWC indicated that it pre-pays the affiliated Service Company for such affiliated Management Fees and wants to revise its filed lead- lag study to reflect a **pre-payment**, on average of 11.25 days. The payment lag applied to Management Fees paid to the affiliate American Water Works Service Company ("AWWSC") and/or to other affiliates should be adjusted to commercially reasonable terms. This substantial affiliated transaction should not be permitted to unnecessarily increase rate base via the creation of an unreasonable CWC requirement. If a utility chooses to pre-pay for affiliate-provided services, on average, before they are provided, ratepayers should not be required to pay a return on the increase to AAWC's rate base that relates to such pre-payment for affiliated services. Mr. Smith therefore adjusted the CWC associated with AAWC's payments to the affiliate AWWSC by applying the same 12-day expense lag associated with AAWC's direct labor costs.

It is also noteworthy that the Company has been unable to show that it requested or that the Commission approved the Affiliate Service Company agreement upon which AAWC is relying upon for the prepayment of such Affiliate Management Fees.

3. Other Expense Adjustments

Schedule B-4 for each district on Attachment RCS-2 (for water) and RCS-3 (for wastewater) also reflects adjustments for operating expense amounts.

Adjustments To Operating Income

C-1, Customer Annualization Correction (Anthem Water District). AAWC's response to RUCO 2-48 says that RUCO witness Rodney Moore found errors in the Company pro forma annualization for Anthem Water, which the Company is accepting and will reflect in their rebuttal. RUCO Adjustment C-1 (as corrected in Mr. Smith's surrebuttal filing) reflects the necessary adjustment to Anthem Water District revenue.

C-2, Rate Case Expense (All Districts). AAWC requested $678,425 for the current case, amortized over three years, plus amortization of the remaining unamortized balance from prior rate cases. The $678,425 is shown on AAWC witness Broderick's Exhibit TMB-2. The amounts requested for the prior rate cases of $149,119 is from AAWC witness Kiger's direct testimony at page 10 and was requested over three years as an amortization in AAWC adjustment MHK-8. RUCO Adjustment C-2 removes the cost for the prior rate case, and provides for an allowance of $460,000 for the current case, normalized over three years, for a normalized annual allowance of $153,333. This normalized allowance is allocated to each district in proportion to its four-factor allocator, as shown on Schedule C-2 in Attachment RCS-2 for water and Attachment RCS-3 for wastewater, respectively.

C-3, Incentive Compensation Expense – AAWC Employees (All Districts). This adjustment removes 30 percent of the incentive compensation expense for AAWC employees that the Company had included in the test year.

C-4, Stock-Based Compensation Expense (All Districts). Ratepayers should not be required to pay executive compensation that is based on the performance of the Company's (or its parent company's) stock price. Additionally, prior to being required to expense stock options for financial reporting purposes under Statement of Financial Accounting Standards No. 123 Revised (SFAS 123R), the cost of stock options was typically treated as a dilution of shareholders' investments, i.e., it was a cost borne by shareholders. While SFAS 123R now requires stock option cost to be expensed on a company's financial statements, this does not provide a reason for shifting the cost responsibility for stock options from shareholders to utility ratepayers. The expense of providing stock options and other stock-based compensation to officers and employees beyond their other compensation should be borne by shareholders and not by ratepayers.

C-5, Normalized Pension Expense (All Districts). AAWC has requested pension expense of $2.090 million, before allocation among districts, for its defined benefit pensions based on funding payments into the defined benefit pension plan trust for 2009. AAWC's requested amount is significantly higher than any amount for the last five years, 2004-2008, as shown in the following table:

Comparison of Annual Pension Amounts

Year		Amount		AAWC Request Exceeds By Amount		Percent
Actual Recorded:						
2004	$	146,893	[a]	$	1,943,107	1322.8%
2005	$	317,798	[a]	$	1,772,202	557.7%
2006	$	1,013,141	[a]	$	1,076,859	106.3%
2007	$	903,222	[a]	$	1,186,778	131.4%
2008	$	1,734,561	[a]	$	355,439	20.5%
Averages:						
2004-2008	$	823,123		$	1,266,877	153.9%
2006-2008	$	1,216,975		$	873,025	71.7%
2007-2008	$	1,318,892		$	771,109	58.5%
AAWC Requested	$	2,090,000	[b]			
RUCO Normalized	$	1,318,892	[c]			

Notes and Source
[a] Annual recorded amounts from response to RUCO 2-60
[b] Company's requested amount is from AAWC Exhibit SLH-2
and is based upon 2009 funding contributions
[c] Based on two-year average, 2007-2008

The 2009 amount used by AAWC is abnormally high, and the unusually high amount appears to be driven by the poor stock market performance that occurred with the worldwide financial crises that began unfolding in the second half of 2008. The amount requested by AAWC does not appear to have been based on its net periodic pension cost that is accrued pursuant to Statement of Financial Accounting Standards No. 87 ("FAS 87') but rather on a funding amount, which is subject to management discretion.

An average of 2007 through 2008 should be used as the basis for a normalized pension expense allowance. Mr. Smith replaced the $2,090,643 abnormally high 2009 result that AAWC used with the $1,318,892 normalized amount based on averaging 2008 and 2009 pension costs using the information provided by AAWC in response to discovery.

C-6, Normalized Other Post Employment Benefits Expense (All Districts). AAWC used an OPEB expense of $95,763, before allocation among AAWC districts and reduced it by a capitalization rate of 18.3 percent, to derive its proposed expense of $78,238. AAWC's request is significantly higher than any amount for the last five years, 2004-2008, as shown in a table presented in Mr. Smith's testimony. RUCO Adjustment C-6,normalizes the OPEB expense, using an average of 2007-2008 as the basis for deriving a normal level for ratemaking purposes. This adjustment reduces the $95,763 amount used by AAWC to $69,163, before capitalization, and reduces the OPEB expense from $78,238 to $56,529, after capitalization. For all of the districts included in the current rate case filing, the adjustment decreases OPEB expense by $10,389.

C-7, Donations, Membership Dues, Advertising and Miscellaneous (All Districts). This adjustment removes expenses for donations, membership dues, certain advertising expense, and miscellaneous expenses, as shown on Attachment RCS-2, Schedule C-7. These costs, which were identified from AWWC's response to RUCO 2-43, are discretionary and not needed for the provision of safe and reliable utility service.

C-8, Tank Maintenance Reserve Fund Accrual (Sun City Water). AAWC has requested an additional expense for Sun City Water of $445,000 annually for a Tank Maintenance Reserve Fund Accrual, as shown on Company Schedule C-2, page 29. RUCO Adjustment C-8 removes the $445,000 additional pro forma accrual that AAWC seeks for Sun City Water to fund a Tank Maintenance Reserve. The Company's request to collect from ratepayers in advance for tank maintenance should be rejected because the tank maintenance expense reserve account balance proposed by the Company is not based on known and measureable Company expenditures and therefore, not necessary or reasonable to adopt the Company's proposal for advance funding of a Reserve for Tank Maintenance at this time. A similar AAWC proposal was opposed by Staff and rejected by the Commission in Decision No. 71410.

Affiliated Management Fees (All Districts)

A number of specific adjustments recommended by Mr. Smith relate to the Affiliate Management Fees.

C-9, Affiliate Management Fees – Remove 4% Increase to "Other Expense". This adjustment removes AAWC's requested post-test year increase to Affiliate Management Fees of 4 percent for "Other Expense". Expense for the five districts is reduced by $81,530.

C-10, Affiliate Management Fees – Remove 22.22% Post Test Year Increase for Affiliate Employee Benefits. This adjustment removes AAWC's requested post-test year increase to Affiliate Management Fees for a 22.22 percent increase in affiliate employee benefit costs, which includes AAWC's request for an abnormally high 2009 amount for pension expense charged to AAWC as a component of the Affiliate Management Fee.

C-11, Affiliate Management Fees – Remove Affiliate Incentive Compensation Expense. This adjustment removes all identifiable incentive compensation expense included in the affiliate Management Fees for the 2008 test year. Expense for the five districts is reduced by $256,853.

C-12, Affiliate Management Fees – Normalize Affiliate Pension Expense. This adjustment normalizes the amount of affiliate pension expense that was included in the Management Fee charges to AAWC for the 2008 test year. The affiliate employees participate in the same AWWC pension plan (subject to eligibility restrictions) as do AAWC employees. Similar to the adjustment for the pension expense for AAWC, discussed above in conjunction with Adjustment

C-5, this adjustment provides for a normalized expense based on a two-year average of 2007-2008. Expense for the five districts is reduced by $4,257.

C-13, Affiliate Management Fees – Normalize Affiliate OPEB Expense. This adjustment normalizes the amount of OPEB expense that was included in the affiliate Management Fee charges to AAWC for the 2008 test year. The affiliate employees participate in the same AWWC OPEB plan (subject to eligibility restrictions) as do AAWC employees. Similar to the adjustment for the OPEB expense for AAWC, discussed above in conjunction with Adjustment C-6, this adjustment provides for a normalized expense based on a two-year average of 2006-2008. Expense for the five districts is reduced by $7,206.

C-14, Affiliate Management Fees – Remove Affiliate "Business Development" Costs. This adjustment removes all identifiable affiliate "Business Development" costs included in the affiliate Management Fees for the 2008 test year. Expense for the five districts is reduced by $48,232. These charges should be removed because they are unnecessary for the provision of safe, reliable and reasonably priced water and wastewater utility service in Arizona. Similar costs were removed by the California PUC in the most recent California American Water rate case.

C-15, Interest Synchronization (All Districts). The interest synchronization adjustment applies the weighted cost of debt to the calculation of test year income tax expense.

C-16, Depreciation Expense (Sun City Water). AAWC's proposed depreciation expense for Sun City Water is reduced by $36,961 based on applying the applicable depreciation rates to the plant adjustment. The related adjustment to plant was discussed above in conjunction with RUCO rate base adjustment B-1.

C-17, Depreciation Expense (Agua Fria Wastewater). This adjustment reduces depreciation expense for Anthem/Agua Fria Wastewater by $2,853 relating to the removal of two 75-horsepower pumps that were retired from plant in service. The retirement of those pumps was covered in RUCO rate base adjustment B-2.

Revenue Requirement

At the time of its direct filing RUCO recommended a revenue increase on adjusted fair value rate base, for each AAWC division, of no more than the amounts listed in the table on page 5 of Mr. Smith's direct testimony, and supported in detail in Mr. Smith's Attachments RCS-2 and RCS-3, for the water and wastewater districts, respectively. Those amounts have been updated in RUCO's surrebuttal filing.

The following is a summary of the significant issues set forth in both the surrebuttal testimony of RUCO witness Ralph C. Smith on Arizona-American Water Company, Inc.'s ("AAWC" or "Company) application for a permanent rate increase. AAWC's filing is based on the calendar test year ended December 31, 2008. RUCO's calculations use the same test year.

Mr. Smith is providing testimony on the following issues: Revenue Requirement; Rate Base; Net Operating Income, including 9 adjustments to AAWC's proposed Rate Base and 20 adjustments to AAWC's proposed Net Operating Income. Each of these adjustments is briefly summarized below. His surrebuttal testimony also addresses a request presented in AAWC's rebuttal testimony for a major new accounting deferral.

Revenue Increases

RUCO recommended a revenue increase on adjusted fair value rate base, for each AAWC division, of no more than the amounts listed in the table on page 3 of Mr. Smith's surrebuttal testimony, and supported in detail in Mr. Smith's Attachments RCS-6 and RCS-7, for the water and wastewater districts, respectively, as follows:

Summary of RUCO Recommended Revenue Increases By District

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Revenue Increase	$ 5,296,426	$ 682,709	$ 5,085,007	$ 1,513,691	$ 783,855	$13,361,688
Adjusted Current Revenues	$ 7,220,082	$ 9,125,203	$ 8,634,567	$ 5,933,970	$ 5,660,389	$36,574,211
% Change	73.36%	7.48%	58.89%	25.51%	13.85%	36.53%

Rate Base

B-1, Post Test Year Plant – Sun City Water. The Company has proposed to include in rate base the cost for a new well that was placed into service on May 27, 2009, at an amount of $1.587 million. This is being removed because it was not in service during the test year and for the other reasons stated in Mr. Smith's direct and surrebuttal testimony. The $1.587 million is not of such magnitude to AAWC such that not including it would jeopardize the utility's financial health. As a portion of AAWC plant of the districts included in the current filing, the $1.587 million is approximately 1.06 percent of the Gross Utility Plant in Service of $149,301,020 that AAWC proposed in its initial filing for the water districts, and is only 0.47 percent of the combined total water and wastewater Gross Utility Plant in Service in AAWC's filing. Additionally, AAWC has failed to demonstrate special or unusual circumstances to justify inclusion of the post test year plant additions in rate base.

B-2, Agua Fria Wastewater – Retirement of Two Effluent Pumps. This adjustment removes from the Agua Fria Wastewater rate base the cost of effluent pumps at the Verrado waste water treatment plant ("WWTP") that were retired during the test year that had an original cost of $52,636.25. AAWC's rebuttal did not contest this adjustment.

B-3, CIAC in CWIP (All Districts Except Sun City West Wastewater). The Company agreed in rebuttal that the full amount of CIAC should be deducted from rate base, so this adjustment is no longer in dispute.

B-4, Cash Working Capital (All Districts).

Mr. Smith's surrebuttal addresses a number of issues with respect to AAWC's proposed Cash Working Capital allowance.

<u>1. Revenue Lag</u>

The revenue lags used by AAWC of over 45 days are considerably longer than the comparable revenue lags used in each of these recent rate cases by other large Arizona utilities that bill their customers monthly.

The Billing Lag days are supposed to measure the time between the reading of the customer's meter and the issuance of the bill. With many modern utilities using automated meter reading and computerized billing software, a Billing Lag exceeding 4 days on average (which is what AAWC is using) also appears to be excessive. The Billing Lag used by AAWC is therefore also a concern. Adjusting the total Revenue Lag by limiting the Collection Lag to the bill payment due date, will resolve the overall concern regarding AAWC's proposed revenue lag, and will provide a total Revenue Lag that is comparable, but at the high end, of the Revenue Lags being used by other large Arizona utilities that bill their customers monthly.

The Company's lead lag study uses a collection lag, by service area, ranging from 26.018 days to 26.091 days. This effectively assumes that customers, on average, throughout the year, are not complying with the payment terms. The payment terms are supposed to be reflected in the dates printed on the customers' bills and with the terms of AAWC's tariff. As discussed in more detail below, the due date for payment of billings for water and wastewater service is 20 days and does not differ by the type of customer.

The collection lag period used by AAWC is excessive and would penalize all customers, including the vast majority of customers that pay their utility bills on time, for the minority of customers who either paying their bills late or do not pay at all (i.e., whose bills become uncollectible).

The collection lag can be distorted by Uncollectibles that remain in Accounts Receivable. Uncollectibles should be removed from the Cash Working Capital calculation. AAWC has agreed with a Staff adjustment to remove Bad Debt Expense from the CWC calculation. The other aspect to Uncollectibles and how it affects Cash Working Capital should also be adjusted. This other aspect of Uncollectibles relates to how long a Company carries them in Accounts Receivable before they are written off or covered by a reserve for Uncollectibles. Recall that AAWC computed its Revenue Lag by dividing Accounts Receivable by 365 days to determine Average Daily Accounts Receivable. Accounts that eventually become uncollectible can distort the Revenue Lag if they are included in Accounts Receivable for lengthy periods of time without having an adequate reserve established.

A reasonable adjustment to the collection lag can be made by applying the 20 day due date period as the maximum collection lag that would apply for customers who, on average, pay their utility bills on time.

The Revenue Lag recommended by Mr. Smith is recommending are near or slightly above the high end of the range of revenue lags used by other large Arizona utilities that bill their customers monthly, which are summarized in the following table:

Revenue Lag
Typical Arizona Utilities That Use Monthly Billing

Utility	Docket	Revenue Lag Days	Reference
APS (Arizona Public Service)	E-01315A-08-0172	38.17	A
TEP (Tucson Electric Power)	E-01933A-07-0402	33.79	B
UNS Gas	G-04204A-08-0571	40.70	C
UNS Electric	E-04204A-09-0206	35.59	D
UNS Electric	E-04204A-06-0783	35.59	E
Southwest Gas Corporation	G-01551A-07-0504	39.53	F

Notes and Source:
[A]: APS workpaper JCL-WP11, p.9
[B]: TEP Schedule B-5, p. 3
[C]: UNSG Schedule B-5, p. 3
[D]: UNSE Schedule B-5, p. 3
[E]: UNSE filing Schedule B-5, p. 3
[F]: SWG Schedule B-5, p. 2

This supports the reasonableness of, and need to use, the revised revenue lags. Also, because the revised revenue lag days recommended for AAWC are at, or slightly above, the high end of the range that has been used by other Arizona utilities, this supports viewing their use as the maximum revenue lag days that would be reasonable to use in determining AAWC's revenue requirement in this case.

This adjustment resulted in the revised revenue lags for each service district as follows:

Adjusted Revenue Lag Days with 20-Day Collection Lag					
Revenue Lag Component	Anthem Water	Sun City Water	Anthem Aqua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
Total Revenue Lag Days	**40.023**	**39.645**	**39.959**	**39.652**	**39.610**

2. Affiliated Service Company Payment Lag

AAWC's rebuttal relies upon an affiliated Service Company agreement that was never approved by the Commission as the basis for AAWC's request to increase the Cash Working Capital Allowance to reflect a prepayment of affiliated Service Company for such affiliated Management Fees on average of 11.25 days. The payment lag applied to Management Fees paid to the affiliate American Water Works Service Company ("AWWSC") and/or to other affiliates should be adjusted to commercially reasonable terms. This substantial affiliated transaction should not be permitted to unnecessarily increase rate base via the creation of an unreasonable CWC requirement. If a utility chooses to pre-pay for affiliate-provided services, on average, before they are provided, ratepayers should not be required to pay a return on the increase to AAWC's rate base that relates to such pre-payment for affiliated services. Mr. Smith therefore adjusted the CWC associated with AAWC's payments to the affiliate AWWSC by applying the same 12-day expense lag associated with AAWC's direct labor costs.

The Affiliate Management Fee paid by AAWC is not the result of an arm's length transaction. It is an affiliated transaction. In order to protect ratepayers from abuses, utility affiliated transactions must be carefully scrutinized. The prepayment provision in the affiliated Service Company agreement does not pass the reasonableness test for ratemaking purposes and should therefore be rejected. If AAWC were obtaining the services from a third party, normal commercially reasonable payment terms would apply. As evidenced by AAWC's payment lags to non-affiliated vendors and employees, such terms would not prepay for services, on average, before such services were provided.

It is also noteworthy that the Company has been unable to show that it requested or that the Commission approved the Affiliate Service Company agreement upon which AAWC is relying upon for the prepayment of such Affiliate Management Fees. Not only was the Service Company agreement relied upon by AAWC apparently never approved by the Commission for any of the districts included in the current AAWC rate case, requiring prepayment of affiliated Management Fee charges would be *prima facie* unreasonable, and such a provision should be rejected in any event for ratemaking purposes.

3. Other Expense Adjustments

Schedule B-4 for each district on Attachment RCS-6 (for water) and RCS-7 (for wastewater) also reflects adjustments for operating expense amounts.

4. Remove Chemical Expense

Staff removed Chemical Expense from the calculation of Cash Working Capital because Chemical Inventory is included in the 13-month average of Materials and Supplies. AAWC witness Gutowski agreed with this Staff adjustment. Mr. Smith also agrees with the Staff's adjustment and has reflected the removal of Chemical Expense on Schedule B-4 of Attachments RCS-6 and RCS-7.

5. Remove Uncollectibles

Staff removed Bad Debt Expense from the calculation of Cash Working Capital because it does not involve a cash outlay, and therefore should have no corresponding expense lag days. AAWC witness Gutowski agreed with this Staff adjustment. Mr. Smith also agree with the Staff's adjustment and have reflected the removal of Bad Debt Expense on Schedule B-4 of Attachments RCS-6 and RCS-7 by reflecting 20.31 day lags for Customer Accounting Expense.

Summary of Adjustments to Cash Working Capital

Cash Working Capital allowance is shown on Attachments RCS-6 and RCS-7, Schedule B-4 for each district, and how it compares with AAWC's request, is summarized in the following table:

Summary of Adjustments to Cash Working Capital

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Adjusted TY Rate Base	$ (121,000)	$ (166,000)	$ (128,000)	$ (104,000)	$ (112,000)	$ (631,000)

B-5, Youngstown Plant – Sun City Water. This adjustment reflects the recommendation made by Staff witness Gerald Becker as it relates to reconciling items related to the Company's Youngstown Plant ("Youngstown") in the Sun City water district that Staff noted during its review of AAWC's workpapers in this proceeding. As shown on Attachment RCS-6, Schedule B-5, these adjustments reduce utility plant in service by $149,497 and accumulated depreciation by $22,008 for a net reduction to rate base in the amount of $127,489 in the Sun City water district.

B-6, Verrado Wastewater Plant – Anthem/Agua Fria Wastewater. This adjustment reflects the recommendation made by Staff witness Gary McMurry as it relates to the Company's Verrado Wastewater Plant ("Verrado"). Mr. McMurry stated that the Company's proposal to include the actual recorded cost of Verrado in rate base does not take into account that Verrado is overbuilt and under-utilized. Therefore, Staff concluded that the excess capacity associated with Verrado should be excluded from rate base and thus, removed $1,838,637 from utility plant in service. Attachment RCS-7, Schedule B-6, reflects the reduction to rate base by $1,838,637 for Anthem/Agua Fria Wastewater.

B-7, Comprehensive Planning Study – Sun City and Sun City West Wastewater. This adjustment reflects the recommendation made by Staff to transfer costs totaling $12,242 associated with a comprehensive planning study that was recorded in the Sun City Wastewater district to the Sun City West Wastewater district since this planning study was in fact conducted for Sun City West Wastewater. Attachment RCS-7, Schedule B-7, shows the reduction to Sun City Wastewater's utility plant in service by $12,242 and increase to Sun City West Wastewater's utility plant in service by the same amount resulting in a net rate base adjustment of zero.

B-8, North West Valley Treatment Plant – Anthem/Agua Fria and Sun City West Wastewater. This adjustment reflects the recommendation made by Staff witness McMurry to update the allocation percentages associated with the North West Valley Treatment Plant ("NWVTP") as it relates to the relative capacity demand between Anthem/Agua Fria Wastewater and Sun City West Wastewater. Staff recommended updating the NWVTP allocation to Anthem/Agua Fria Wastewater from 32 percent to 28 percent. In addition, Staff recommended updating the NWVTP allocation to Sun City West Wastewater from 68 percent to 72 percent. Attachment RCS-7, Schedule B-8, shows that updating the NWVTP allocation percentages results in a decrease to utility plant in service for Anthem/Agua Fria Wastewater in the amount of $1,039,823 and an increase to utility plant in service for Sun City West Wastewater for the same amount, which results in a net adjustment to utility plant in service of zero. There is also a related adjustment to Accumulated Depreciation.

B-9, Accumulated Deferred Income Taxes. This adjustment incorporates the recommendation made by Staff witnesses Becker and McMurry to reflect in rate base the accumulated deferred income taxes ("ADIT") that were recorded in the Company's audited financial statements. AAWC proposed allocating ADIT of approximately $13.026 million to each district in this proceeding based on its four-factor allocation, but Staff was unable to reconcile the $13.026 million figure to the Company's audited financial statements' ADIT balance of $12.689 million. Attachment RCS-6, Schedule B-9, shows that the incorporation of Staff's recommended adjustments reduces ADIT (thus increasing rate base) by a total amount of $173,965. Acceptance of this adjustment in this rate case, however, should not be construed as an endorsement of each component included in the ADIT balance. AAWC's ADIT balance is a net addition to rate base and may include components that would require adjustment in a future case if a detailed analysis were undertaken.

Other Rate Base Adjustments. Two additional adjustments that were recommended by Staff that were accepted by the Company. The first such adjustment relates to the transfer of $22,289, which was for chemical feed and water quality monitoring equipment, that Staff recommended be reclassified from Account 304300 to Account 320100. The second such adjustment relates to the transfer of $487,000, which was for a power generator, that Staff recommended be reclassified from Account 354400 to Account 355500. Since both of these adjustments merely reclassify amounts from one account to another, there is no net impact on RUCO's proposed rate base or revenue requirement. Therefore, it was not necessary to present schedules for either of these adjustments. These adjustments do, however, have a net impact on Depreciation Expense, which is addressed below in Adjustments C-18 and C-19.

Adjustments To Operating Income

C-1, Customer Annualization Correction (Anthem Water District). RUCO Adjustment C-1 (as corrected in Mr. Smith's surrebuttal filing) reflects the necessary adjustment to Anthem Water District revenue for an error in AAWC's calculations that was discovered by RUCO witness Rodney Moore.

C-2, Rate Case Expense (All Districts). AAWC requested $678,425 for the current case, amortized over three years, plus amortization of the remaining unamortized balance from prior rate cases. The $678,425 is shown on AAWC witness Broderick's Exhibit TMB-2. The amounts requested for the prior rate cases of $149,119 is from AAWC witness Kiger's direct testimony at page 10 and was requested over three years as an amortization in AAWC adjustment MHK-8. RUCO Adjustment C-2 removes the cost for the prior rate case[1], and provides for an allowance of $460,000 for the current case, normalized over three years, for a normalized annual allowance of $153,333. This normalized allowance is allocated to each district in proportion to its four-factor allocator, as shown on Schedule C-2 in Attachment RCS-6 for water and Attachment RCS-7 for wastewater, respectively.

C-3, Incentive Compensation Expense – AAWC Employees (All Districts). This adjustment removes 30 percent of the incentive compensation expense for AAWC employees that the Company had included in the test year.

C-4, Stock-Based Compensation Expense (All Districts). The expense of providing stock options and other stock-based compensation to officers and employees beyond their other compensation should be borne by shareholders and not by ratepayers. AAWC's rebuttal has agreed to remove stock-based compensation expense.

[1] AAWC's rebuttal has agreed to withdraw that component of its requested rate case expense.

C-5, Normalized Pension Expense (All Districts). AAWC has requested pension expense of $2.090 million, before allocation among districts, for its defined benefit pensions based on funding payments into the defined benefit pension plan trust for 2009.

The 2009 amount used by AAWC is abnormally high, and the unusually high amount appears to be driven by the poor stock market performance that occurred with the worldwide financial crises that began unfolding in the second half of 2008. The amount requested by AAWC does not appear to have been based on its net periodic pension cost that is accrued pursuant to Statement of Financial Accounting Standards No. 87 ("FAS 87') but rather on a funding amount, which is subject to management discretion.

AAWC's requested amount is significantly higher than any amount for the last five years, 2004-2008, as shown in the following table:

Comparison of Annual Pension Amounts

				AAWC Request Exceeds	
Year		Amount		By Amount	Percent
Actual Recorded:					
2004	$	146,893	[a]	$ 1,943,107	1322.8%
2005	$	317,798	[a]	$ 1,772,202	557.7%
2006	$	1,013,141	[a]	$ 1,076,859	106.3%
2007	$	903,222	[a]	$ 1,186,778	131.4%
2008	$	1,734,561	[a]	$ 355,439	20.5%
Averages:					
2004-2008	$	823,123		$ 1,266,877	153.9%
2006-2008	$	1,216,975		$ 873,025	71.7%
2007-2008	$	1,318,892		$ 771,109	58.5%
AAWC Requested	$	2,090,000	[b]		
RUCO Normalized	$	1,318,892	[c]		

Notes and Source
[a] Annual recorded amounts from response to RUCO 2-60
[b] Company's requested amount is from AAWC Exhibit SLH-2 and is based upon 2009 funding contributions
[c] Based on two-year average, 2007-2008

An average of 2007 through 2008 (preferably using the FAS 87 amounts rather than funding contributions) should be used as the basis for a normalized pension expense allowance. Mr. Smith replaced the $2,090,643 abnormally high 2009 result that AAWC used with the $1,318,892 normalized amount based on averaging 2008 and 2009 pension costs using the information provided by AAWC in response to discovery.

In the American Water Works Company, Inc. ("AWWC", AAWC's parent company), 2008 SEC Form 10-K (filed 2/27/09) at page 28, investors have been put on notice by AWWC that the:

> **The disruption in the capital markets** and its actual or perceived effects on particular businesses and the greater economy **also adversely affects the value of the investments held within the Company's employee benefit plan trusts. Significant declines in the value of the investments held within the Company's employee benefit plant trusts may require the Company to increase contributions to those trusts in order to meet future funding requirements if the actual asset returns do not recover these declines in value in the foreseeable future. These trends may also adversely impact** the Company's results of operations, net cash flows and financial positions, including our **shareholder's equity.**
> (Emphasis supplied.)

AWWC has already put its shareholders on notice that "**increases in pension and other postretirement costs as a result of reduced plan assets may not be fully recoverable from our customers.**"

Finally, it is not essential that AAWC recover an abnormal level of pension (or OPEB) expense, especially when the level of pension expense being requested by the Company has increased so significantly because of capital market disruptions and abnormally poor investment market performance. What is essential is that the Commission balance the interests of ratepayers and shareholders, and, where necessary, hold shareholders responsible for cost increases. AAWC's request for 2009 or even an average of 2009 or 2010 pension expense should be rejected. There is no requirement that a utility like AAWC be allowed to recover "actual" expenses for pensions or other items when those expenses are at abnormal levels due to unprecedented capital market disruptions and where the utility's requested amounts are for periods beyond the test year.

In summary, instead of modifying its large pension increase that was reflected in its direct filing, AAWC's rebuttal testimony attempts to increase pension expense even more. At page 16 of AAWC witness Kiger's rebuttal testimony AAWC attempts to increase pension expense by an additional $72,296 for the five districts for affiliated pension expense. Mr. Smith addresses this AAWC proposal in conjunction with Adjustment C-12, discussed subsequently in his surrebuttal testimony.

AAWC's Recordation of "Regulatory Assets" for Pension Cost Deferrals. AAWC witness Broderick requests that, if the Commission decides to approve FAS 87 based pension expense in this case, AAWC wants to charge ratepayers for prior differences between FAS 87 and ERISA, based on amounts that AAWC has deferred in accounts 186408 and 186422 over a five-year period. This AAWC request should be rejected because to date, other than citing Decision No. 58419, which did not authorize a regulatory asset, and which applied to Paradise Valley, not to any of the districts at issue in the current AAWC rate case, AAWC has provided nothing of reliable substance that would justify charging ratepayers of any of the AAWC utilities in the current rate case for a multi-million dollar pension "regulatory asset" that was apparently never clearly presented by AAWC to the Commission or authorized by the Commission for the specific water and wastewater utilities whose revenue requirements are at issue in the current AAWC rate case. This request by AAWC for amortization of a pension "regulatory asset" should be rejected. In addition to being inappropriate and apparently without proper Commission authorization with respect to the deferral, such an amortization in the current case would exacerbate the shockingly high pension expense increases that the Company is requesting in the current rate case.

AAWC and its parent company, AWWC, both apply accrual accounting under FAS 87 for financial reporting purposes. For example, AWWC's Securities and Exchange Commission ("SEC") Form 10-K for the period ending 12/31/2008 at page 127 shows Net periodic pension benefit cost for 2006, 2007 and 2008 of $35.011 million, $32.329 million and $32,886 million, respectively.

AAWC indicted in response to discovery that it has established a "regulatory asset" for differences between funding and FAS 87. AAWC's responses to discovery in the current rate case indicate that the Company is relying upon Decision No. 58419 for its justification for establishing a pension "regulatory asset"; however, Decision No. 58419 was issued in September 1993 for Paradise Valley Water and thus applied to Paradise Valley and not to other utilities operating in Arizona that AAWC did not even own at that time. Moreover, Decision No. 58419 reflected a Staff adjustment in that case to reduce Paradise Valley's requested pension expense by $17,320 for the differences between FAS 87 and funded pension expense. At page 8, lines 9-16, that Decision stated that:

> In its rebuttal testimony, the Company agreed to Staff's pro forma adjustment on the condition that the Commission allow the Company to establish and maintain a regulatory asset for SFAS 87 costs.
>
> We agree that it is appropriate to exclude the $17,320 and that the Company should establish a deferral account as a result of its implementation of SFAS 87, for possible recovery in a future rate application.

In summary, $17,230 was excluded and Decision No. 58419 states that "the Company should establish a deferral account as a result of its implementation of SFAS 87, for possible recovery in a future rate application." This says "possible" recovery, not "probable" recovery, which is often cited as one of the criteria for establishing a regulatory asset under FAS 71. At page 8, Decision No. 58419 says that Paradise Valley should establish a "deferral account" not a "regulatory asset" account. To accountants, there is a difference between a mere "deferral account" and a regulatory asset. Also, there is nothing in the "Findings of Fact" on pages 19-21, or the "Order" provisions at pages 21-23 of Decision No. 58419 that instruct Paradise Valley to establish a regulatory asset for pension-based differences. In sum, AAWC's apparent heavy reliance upon

Decision No. 58419 as authorizing a "regulatory asset" for pensions, even for Paradise Valley Water Company, may have been misplaced.

AAWC's Request to Defer Pension Expense. AAWC witness Broderick's rebuttal testimony at page 13 cites a request made by AAWC for approval to defer $1.723 million in 2009 pension expense and to continue such deferral through December 31, 2013. This AAWC request is apparently pending in another Docket (09-0241); however, this is directly related to a major issue in the current AAWC rate case – determining a reasonable and normal allowance for pension expense for ratemaking purposes. The Company's position that it should be allowed to charge ratepayers for every dollar of its "actual" or "exact" pension expense, even when such expense is abnormally high as the result of unprecedented capital market disruptions should be rejected. No deferrals of 2009 pension expense should be permitted. The Company's requested double-digit rate increases are bad enough without placing additional burdens on ratepayers to pay additional amounts in subsequent AAWC rate cases for deferrals of abnormally high 2009 pension expense. The Company's request for single issue ratemaking via "a balancing account feature" for "exact" recovery of pension expense in periods not corresponding to a rate case test year should be rejected.

AAWC's Request to Charge Ratepayers for an Amortization of a Pension "Regulatory Asset". Pages 13-15 of AAWC witness Broderick's rebuttal testimony request additional charges to ratepayers for amortization and rate base inclusion of differences that AAWC deferred on its books for the difference between FAS 87 and ERISA-funded amounts for pensions. AAWC has apparently recorded on its books in Accounts 186408 and 186422, without any clear Commission authorization, amounts which total $746,347 and $1,050,173 as of February 28, 2010, and is apparently requesting a five-year amortization of such amounts (which AAWC apparently wants to update even further beyond the 2008 test year), and for inclusion in rate base of the unamortized balances. There are several problems and concerns with regard to this AAWC request. First, AAWC has not demonstrated that it ever requested or received Commission authorization to record such deferrals for any of the districts at issue in the current AAWC rate case. The only thing AAWC has been able to point to as potentially authorizing a deferral is Decision No. 58419, which only addressed a minimal deferral for Paradise Valley.

Additionally, there is an element of retroactive ratemaking in AAWC's proposal. For AAWC to have assumed that it could defer differences between FAS 87 and ERISA without obtaining specific Commission authorization for such deferrals is questionable at best. If the deferrals that AAWC recorded were not specifically authorized by the Commission, the amounts should be written off. From the documentation provided to date by AAWC, it appears the Company has not cited adequate authorization for such deferrals for the districts in the current AAWC rate case, and it was therefore questionable at best for such amounts to have been deferred on AAWC's books. As noted above, FAS 87 has been in existence for over 20 years.

Finally, the total amount of pension expense being included in rates should be reviewed for reasonableness and adjusted to a reasonable and normal level. AAWC's initially filed request, which was based on a 2009 amount that had been impacted by unprecedented disruptions in the capital markets, is too high and is based on abnormal conditions, and should therefore be adjusted downward using a historical average as I have recommended. Loading additional pension expenses into the 2008 test year based on questionable prior deferrals, and inclusion of such deferral balances in rate base as requested by AAWC is not appropriate and should be rejected.

C-6, Normalized Other Post Employment Benefits Expense (All Districts). RUCO Adjustment C-6 normalizes the OPEB expense, using an average of 2007-2008 as the basis for deriving a normal level for ratemaking purposes. This adjustment reduces the $95,763 amount used by AAWC to $69,163, before capitalization, and reduces the OPEB expense from $78,238 to $56,529, after capitalization. For all of the districts included in the current rate case filing, the adjustment decreases OPEB expense by $10,389.

C-7, Donations, Membership Dues, Advertising and Miscellaneous (All Districts). This adjustment removes expenses for donations, membership dues, certain advertising expense, and miscellaneous expenses because they are discretionary and not needed for the provision of safe and reliable utility service.

C-8, Tank Maintenance Reserve Fund Accrual (Sun City Water). AAWC has requested an additional expense for Sun City Water of $445,000 annually for a Tank Maintenance Reserve Fund Accrual, as shown on Company Schedule C-2, page 29. RUCO Adjustment C-8 removes the $445,000 additional pro forma accrual that AAWC seeks for Sun City Water to fund a Tank Maintenance Reserve. The Company's request to collect from ratepayers in advance for tank maintenance should be rejected because the tank maintenance expense reserve account balance proposed by the Company is not based on known and measureable Company expenditures and therefore, not necessary or reasonable to adopt the Company's proposal for advance funding of a Reserve for Tank Maintenance at this time. A similar AAWC proposal was opposed by Staff and rejected by the Commission in Decision No. 71410.

Recording expenses as they are incurred typically involves crediting Cash or Accounts Payable and debiting (charging) an Expense when a cost is actually incurred. In contrast, charges to expense for a Reserve Accrual records the expense before it is incurred. The use of a Reserve Accrual essentially results in ratepayers pre-paying for the expense. Also, because of the operation of the Reserve account, this also contains undesirable elements of single-issue ratemaking, where a specific expense item, in this case Tank Painting, is singled out from all of the utility's other expenses, and essentially gets tracked (in the Accrued Reserve Account) for dollar-for-dollar recovery. As such, unless there is a very compelling reason for establishing a Reserve Fund Accrual, this single-issue approach to utility regulation is undesirable, and has the impact of shifting responsibility of fluctuations in the expense between rate cases away from the utility and onto ratepayers, and requires ratepayers to pre-pay for expenses before they are incurred by the utility, and should therefore be rejected.

Anthem Water Tank Maintenance Reserve Fund Accrual. Mr. Brodericks' rebuttal testimony at page 10, AAWC is now apparently also requesting that a tank painting and inspections deferral be approved for Anthem Water District. As noted above, such Reserve Fund Accruals require pre-payment by ratepayers of expenses before they are incurred by the utility, and have undesirable features associated with single-issue ratemaking. Additionally, AAWC has not demonstrated that a Tank Maintenance Reserve Fund Accrual is necessary, reasonable or appropriate for Anthem Water at this time. Consequently, AAWC's rebuttal filing request for authorization for a Reserve Fund Accrual for Anthem Water should be rejected.

Affiliated Management Fees (All Districts)

A number of specific adjustments recommended by Mr. Smith relate to the Affiliate Management Fees.

C-9, Affiliate Management Fees – Remove 4% Increase to "Other Expense". This adjustment removes AAWC's requested post-test year increase to Affiliate Management Fees of 4 percent for "Other Expense". Expense for the five districts is reduced by $81,530.

C-9A, Affiliate Management Fees – 4% Affiliated Service Company Marcy 2009 Pay Increase." Mr. Smith's direct testimony had allowed the 4 percent affiliated Service Company pay increase that AAWC represents occurred in March 2009. Based on Commissioner interest in the recent open meeting in a UNS Gas rate case concerning utility post-test year pay increases, and RUCO's own re-evaluation of this issue in view of the economic circumstances, RUCO has requested that the 4% affiliated post test year pay increase be removed from test year operating expenses the affiliated Service Company's post test year pay increase. Mr. Smith removed this affiliate post test year pay increase in RUCO Adjustment C-9A. This adjustment reduces AAWC's requested operating expenses for the six districts by $89,678.

C-10, Affiliate Management Fees – Remove 22.22% Post Test Year Increase for Affiliate Employee Benefits. This adjustment removes AAWC's requested post-test year increase to Affiliate Management Fees for a 22.22 percent increase in affiliate employee benefit costs, which includes AAWC's request for an abnormally high 2009 amount for pension expense charged to AAWC as a component of the Affiliate Management Fee. AAWC's parent company, AWWC has already put its shareholders on notice, per page 28 of AWWC's SEC Form 10-K, that "increases in pension and other postretirement costs as a result of reduced plan assets may not be fully recoverable from our customers."

AAWC witness Kiger's rebuttal position stated at page 12, lines 16-18 that "Arizona-American must recover all of its known and measureable pension expense, especially pension expense related to the Service Company, in order for it to recover its cost of service." This AAWC position is flawed because the function of ratemaking is not to guarantee that a utility can collect from ratepayers all of its expenses, including expenses that are unusually high during periods outside of a test year because of unprecedented market conditions. Rather a reasonable and normal amount of expenses should be allowed. AAWC's 2009 pension expense, including the Service Company portion that is charged to AAWC through the affiliated Management Fee is abnormally high in comparison with historical levels of such expense, and the reason it is abnormally high is due to unusual and perhaps unprecedented investment market conditions that were experienced. Such market conditions have alleviated somewhat, as evidenced by the negative pension plan asset return achieved by AWWC in 2008 versus the relatively robust return achieved in 2009. Basing rates on a 2009 amount of pension or OPEB expense for AAWC directly or for the affiliated Service Company, as AWWC has requested, should be rejected.

C-11, Affiliate Management Fees – Remove Affiliate Incentive Compensation Expense. This adjustment removes all identifiable incentive compensation expense included in the affiliate Management Fees for the 2008 test year. Expense for the five districts is reduced by $256,853.

A 30 percent disallowance for incentive compensation was used for AAWC employees and for allocated Service Company incentive compensation in recent prior AAWC rate cases, including Decision Nos. 71410 and 68858. This was apparently done because the parties to those prior cases, which included AAWC, Staff and RUCO, did not attempt to distinguish the source of the financial trigger leading to the payment of incentive compensation.

The AIP plan indicates that, in 2008, more than 85% of the operating income target for the entire Company had to be achieved before incentive compensation was awarded based on the corporate financial component of the Plan, although such an award could be made on the Divisional/Regional and State financial components if operating income exceeded 85% of the target. In addition, more than 75% of the Corporate operating income target had to be achieved in order for any payments to be made on any components of the Plan for the entire Company. Consequently, I believe it is reasonable and appropriate to exclude 100 percent of the incentive compensation expense that is charged to AAWC for affiliated Service Company employees as part of the American Water Works Management Fee charges. American Water Works corporate financial income is only moderately influenced by AAWC profits and is heavily influenced by non-Arizona jurisdictional operations, and is also impacted by American Water Works' non-regulated operations.

Additionally, Karla O. Teasley, the President of Illinois-American Water Company has acknowledged in public testimony that her water utility (which is an affiliate of AAWC) has been denied recovery of incentive compensation expense by the regulatory authority in that jurisdiction due to the presence of a parent company financial trigger.[2] Additionally, in a recent decision, the West Virginia Commission (while allowing utility direct incentive compensation expense) disallowed affiliate incentive compensation expense (as well as merit increases for utility employees) because such expenses were determined to be unreasonable during periods of economic hardship and high unemployment, and consequently were deemed to not meet a prudence test given the recent financial conditions and economic turmoil.[3]

C-12, Affiliate Management Fees – Normalize Affiliate Pension Expense. This adjustment normalizes the amount of affiliate pension expense that was included in the Management Fee charges to AAWC for the 2008 test year. The affiliate employees participate in the same AWWC pension plan (subject to eligibility restrictions) as do AAWC employees. Similar to the adjustment for the pension expense for AAWC, discussed above in conjunction with Adjustment C-5, this adjustment provides for a normalized expense based on a two-year average of 2007-2008. Expense for the five districts is reduced by $4,257.

C-13, Affiliate Management Fees – Normalize Affiliate OPEB Expense. This adjustment normalizes the amount of OPEB expense that was included in the affiliate Management Fee charges to AAWC for the 2008 test year. The affiliate employees participate in the same AWWC OPEB plan (subject to eligibility restrictions) as do AAWC employees. Similar to the adjustment for the OPEB expense for AAWC, discussed above in conjunction with Adjustment C-6, this adjustment provides for a normalized expense based on a two-year average of 2006-2008. Expense for the five districts is reduced by $7,206.

C-14, Affiliate Management Fees – Remove Affiliate "Business Development" Costs. This adjustment removes all identifiable affiliate "Business Development" costs included in the affiliate Management Fees for the 2008 test year. Expense for the five districts is reduced by $48,232. These charges should be removed because they are unnecessary for the provision of safe, reliable and reasonably priced water and wastewater utility service in Arizona. Similar costs were removed by the California PUC in the most recent California American Water rate case, and AAWC agreed in its rebuttal to remove this expense.

C-15, Interest Synchronization (All Districts). The interest synchronization adjustment applies the weighted cost of debt to the calculation of test year income tax expense.

C-16, Depreciation Expense (Sun City Water). AAWC's proposed depreciation expense for Sun City Water is reduced by $36,961 based on applying the applicable depreciation rates to the

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[2] See excerpt from her testimony in ICC Docket 09-0319, included in Attachment RCS-8.
[3] Excerpts from an Order dated November 30, 2009, of the West Virginia Commission in a rate case decision involving Dominion Hope Gas are also included in Attachment RCS-8.

plant adjustment. The related adjustment to plant was discussed above in conjunction with RUCO rate base adjustment B-1.

C-17, Depreciation Expense (Agua Fria Wastewater). This adjustment reduces depreciation expense for Anthem/Agua Fria Wastewater by $2,853 relating to the removal of two 75-horsepower pumps that were retired from plant in service. The retirement of those pumps was covered in RUCO rate base adjustment B-2.

C-18, Depreciation Expense (Anthem Water). This adjustment increases Depreciation Expense for Anthem Water by $1,202 to reflect the impact related to the reclassification of $22,289 form Account 304300 to Account 320100 described above in "Other Rate Base Adjustments."

C-19, Depreciation Expense (Anthem/Agua Fria Wastewater). This adjustment increases Depreciation Expense for Anthem/Agua Fria Wastewater by $13,392 for the reclassification of $487,000 from Account 354400 to Account 355500 described above in "Other Rate Base Adjustments."

AAWC's Rebuttal Request for a Major New Accounting Deferral

AAWC witness Kiger's rebuttal testimony has presented a new Company request for a major new accounting deferral. Specifically, AAWC seeks authority to defer replacement costs paid to the City of Glendale in association with the 99th Avenue Interceptor, pursuant to a City of Glendale Sewage Transportation Agreement ("Glendale Agreement"). There are concerns about this large and apparently at least partially retroactive billing. At page 3, line 19 of his rebuttal, Mr. Kiger states that the $917,906 relates to replacements that occurred from December 2005 to April 2009. This raises issues about retroactive cost recovery. Singling out such a billing for special accounting or ratemaking treatment also raises concerns about single-issue ratemaking. Because of the timing of its request – presented for the first time in rebuttal – and because of such other concerns briefly described above, this request by AAWC for a major new accounting deferral should be rejected in the current AAWC rate case.